2004

CPA expert 2004 winter

American Institute of Certified Public Accountants

CPA Expert

AICPA Newsletter for Providers of Business Valuation & Litigation Services

Winter 2004

Contents

EXPERT SPOLIATION

By Gregory P. Joseph

Can an attorney properly instruct experts to destroy drafts of their reports as they are working toward the final? Does it matter whether those drafts bear or reflect the comments of others? What if the comments reflected on the drafts are the attorney's? Must communications with experts—including emails—be preserved? Are the attorney's notes of conversations with his or her own experts discoverable?

We live in an era of spoliation. Parties long not so much for documentary evidence as for evidence that documents have been destroyed. This article explores the application of spoliation principles to expert-related materials.

The threshold question is whether the materials are discoverable. If so, there is necessarily a duty to preserve them since by definition there is a pending or reasonably foreseeable lawsuit. (*West* v. *Goodyear Tire & Rubber Co.,* 167 F.3d 776, 779 (2d Cir. 1999)).

IMPACT OF REPORT REQUIREMENT

The discoverability of expert-related materials turns largely on an analysis of the Federal Rules of Civil Procedure (Fed. R. Civ. P.) 26(a)(2)(B), the expert report requirement added in 1993. This rule mandates disclosure not only of "a complete statement of all opinions" but also of "*the data or other information considered by the witness in forming the opinions.*" The critical word is *considered.* The 1991 draft of this rule originally proposed "relied," but that was deleted as too restrictive.

"*Considered,* which simply means 'to take into account,' clearly invokes a broader spectrum of thought than the phrase 'relied upon,' which requires dependence on the information." (*Karn* v. *Ingersoll Rand,* 168 F.R.D. 633, 639 (N.D. Ind. 1996)) ("Considered" is satisfied where experts have "reviewed" documents "related to the subject matter of the litigation…in connection with forming their opinions"). The 1993 Advisory Committee Note to Rule 26(a)(2)(B) observes that "Given the obligation of disclosure, litigants should no longer be able to argue the materials furnished to their experts to be used in forming their opinions are protected from disclosure when such persons are testifying or being deposed."

Therefore, matters considered by experts are generally disclosable in their reports and, therefore, discoverable. This includes documents provided by counsel to the expert and the expert's draft reports and notes. (*Corrigan* v. *Methodist Hosp.,* 158 F.R.D. 54, 58 (E.D. Pa. 1994); *Ladd Furniture* v. *Ernst & Young,* 1998 U.S. Dist. LEXIS 17345 at *34 (M.D.N.C. Aug. 27, 1998); *Hewlett-Packard* v. *Bausch & Lomb,* 116 F.R.D. 533, 537 (N.D. Cal. 1997)).

Consequently, ordering experts to destroy drafts and notes is generally sanctionable. (*W.R. Grace & Co.* v. *Zotos Int'l, Inc.,* 2000 WL 1843258 at *10-*11 (W.D.N.Y. Nov. 2, 2000)). There are, however, a series of open issues—and a fundamental question of whether this result is always the right one.

CONSULTING EXPERTS' COMMENTS

What if the drafts bear the comments of non-testifying consulting experts whose work product is generally non-discoverable, subject to the "exceptional circumstances" test of Rule 26(b)(4)?

An important 2001 opinion, *Trigon Ins. Co.* v. *United States,* 204 F.R.D. 277 (E.D. Va. 2001), holds that this material is discoverable. The defendant in *Trigon* retained a respected litigation consulting firm to supply experts (third-party academics) and to assist those experts in preparing their reports. The consulting firm and its principals remained non-testifying experts. The plaintiff sought all drafts worked up between the testifying experts and the consulting firm, and all communications (including email traffic) between them, much of which had not been preserved.

The *Trigon* Court held that since the drafts and substantive emails had been "considered" by the testifying experts in forming their opinions, the materials were discoverable. *Trigon* further ruled that the destruction of these materials was sanctionable because it was intentional, and that spoliation remedies attached regardless of whether the defendant acted in bad faith.

The Court did not preclude the experts' testimony because that would have interposed a delay prejudicial to the plaintiff (the court would have permitted the defendant to engage new experts). Instead, the *Trigon* Court ordered the defendant to engage an outside technology consultant to retrieve as much of the data as possible—with the plaintiff's full participation in the process—and held it "appropriate to draw adverse inferences respecting the substantive testimony and credibility of the experts." *Id.* at 291.

In a late 2002 opinion, the *Trigon* Court also awarded the plaintiff more than $179,000 in fees and costs attributable to the spoliation. (*Trigon Ins. Co.* v. *United States,* 2002 U.S. Dist. LEXIS 24782 at *7 (Dec. 17, 2002)).

Interestingly, at the same time that it found sanctionable the destruction of drafts bearing the comments of other experts, the *Trigon* opinion stressed that it was not deciding "whether a testifying expert is required to retain, and a party is required to disclose, the drafts prepared solely by [the testifying] expert while formulating the proper language in which to articulate that experts' own, ultimate opinion arrived at by the experts' own work or those working at the expert's personal direction" and that "*[t]here are cogent reasons which militate against such a requirement....*" (204 F.R.D. at 283 n.8).

These cogent reasons were not specified, and, as noted above, other cases expressly allow discovery of draft reports and notes. At least one federal judge has issued a Standing Order requiring their production. (See *Supplemental Order to Order Setting Case Management Conference in Civil Cases Before Judge William Alsup* at ¶15 (N.D. Cal. November 25, 2002)).

There are cogent reasons, however, why the Advisory Committee should reconsider whether this is the optimal result. Every carefully drafted document has false starts. The quality of the final is not judged by the quantity or quality of the drafts. That is true of judicial opinions and briefs as well as expert reports. For the expert to formulate a reasoned opinion, he or she should be afforded the latitude to filter the facts through the prism of his or her expertise—using whatever process seems most appropriate—without intrusion and without the necessity of attempting to avoid committing matters to writing. If the concern is ghost-writing or undue influence by others, a party should be required to make a prima facie showing that validates that concern before piercing the report and opening underlying matters to discovery.

Regrettably, the proposed distinction in *Trigon* between the work-product generated by "those working at the expert's personal direction" and that of the outside consulting litigation firm is also difficult to sustain under Rule 26(a)(2)(B). Moreover, if it were sustained, the expert industry would no doubt be restructured so that experts relied only on "employees." But if the relevant concern is ghost-writing, there is no obvious reason why the courts should treat ghost-writing by employees differently from that of third-parties. The element of personal direction is really the key, and the question is always the same whether the expert is giv-

CPA Expert, Winter 2004, Volume 9, Number 3. Published by the American Institute of Certified Public Accountants. Harborside Financial Center, 201 Plaza Three, Jersey City, N.J. 07311-3881. Printed in the U.S.A. Subscription rates: $76 a year; for AICPA members, $72; for members of the AICPA CS Section, $36. To order call 888-777-7077.

ing the direction or receiving it: Is there a genuine issue as to just whose opinion the expert is espousing?

COUNSEL'S COMMUNICATIONS WITH EXPERTS

The issue discoverability of communications between counsel and experts has split the courts since 1993. (*See generally* 6 MOORE'S FEDERAL PRACTICE § 26.80[1][a] (3d ed. 2002)). The technical issue is whether the protection for opinion work product set forth in Rule 26(b)(3) is trumped by the disclosure requirement of Rule 26(a)(2)(B). Many courts, like *Karn*, hold that it is and that all communications between counsel and the expert are discoverable. Others, following *Haworth, Inc.* v. *Herman Miller, Inc.*, 162 F.R.D. 289 (W.D. Mich. 1995), come to the opposite conclusion.

I have advocated the latter position (*Emerging Expert Issues Under the 1993 Disclosure Amendments to the Federal Rules of Civil Procedure,* 164 F.R.D. 97 (1996)), but the trend of decisions appears now to favor the *Karn* approach. That approach fairly addresses the perceived need to explore the basis of the expert's opinion. It is overly broad, however, capturing every exchange between counsel and the expert, regardless of the substance and regardless of whether there is any doubt that the opinion is in all respects that of the witness. This result operates to favor those litigants who can afford separate consulting experts off whom, for example, counsel may bounce ideas about cross of opposing experts and trial strategy.

In those jurisdictions following the *Karn* approach, drafts of expert reports bearing counsel's comments are discoverable. (*Weil* v. *Long Island Savings Bank,* 206 F.R.D. 38 (E.D.N.Y. 2001)). There is the further question of the discoverability of counsel's notes reflecting oral communications with the expert. This is one step removed from the actual communications—assuming that the expert has never seen the notes—and necessarily implicates serious opinion work product concerns. The notes should be deemed immune from discovery, absent a *prima facie* showing that (1) they reflect either misconduct or ghost-writing by counsel or form an important basis of the expert's opinion, and (2) they cannot be recreated in any other way (for example, from testimony from the expert). Some courts have properly shown reticence in ordering production of such notes. (See, for example, *B.C.F. Oil Refining* v. *Consol. Edison Co. of N.Y.,* 171 F.R.D. 57, 66-67 (S.D.N.Y. 1997). *W.R. Grace,* 2000 WL 1843258 at *5; *Amster* v. *Tiver Capital Int'l Group,* 2002 U.S. Dist. LEXIS 13669 (S.D.N.Y. July 26, 2002)).

PRACTICE POINTERS

This discussion suggests the following practice pointers:

1. Each expert should, on retention, be made aware that everything he or she writes or receives, including every email, is potentially discoverable. Nothing should be discarded or purged (better yet, nothing written). This should be added to the expert retention letter, to show counsel's diligence in this regard. Special efforts must be undertaken by those experts working for organizations whose electronic documents are regularly purged to ensure that potentially discoverable material is not destroyed.
2. Lawyers should curtail their written communications with experts, and those of others, like consulting experts (whose engagement letter should similarly afford notice of the preservation obligation). There is no duty to create exhibits for your adversary.
3. Lawyers should be conscious of the risk that notes of conversations with experts may be discoverable. For years lawyers have urged clients not to take notes. Now, it's their turn.
4. Even if draft expert reports are discoverable, there is no obligation to create them. There is no prohibition against having an expert work on a single version of a single electronic document. This will not prevent the adversary from requesting the hard drive of the expert's computer to see what can be electronically discerned. That, however, is expensive and less likely than a routine request for hard copies.
5. A lawyer should be slow to request any of this discovery from an adversary. The lawyer, too, has an expert. It is effectively impossible to ensure that no potentially responsive documents are lost, however hard a lawyer tries. Mutual assured destruction worked for decades. It still has legs.

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Letters to the Editor

CPA Expert encourages readers to write letters on issues related to business valuation and litigation and dispute resolution services and on published articles. Please include your name and telephone and fax numbers. Send your letters by e-mail to wmoran@aicpa.org.

A NEW LOOK AT EXPECTED CASH FLOWS AND PRESENT VALUE DISCOUNTS

By Hal Rosenthal, CPA, CFE

CPAs who calculate the present value of expected cash flows as a basis to determine economic damages, the value of business assets and liabilities or entire businesses are, knowingly or unknowingly, functioning in the realm addressed by FASB Concept Statement No. 7 (Con 7), *Using Cash Flow Information and Present Value in Accounting Measurements,* which deals with measurement of fair value in accounting using present value. The focus of this article is Con 7 in the context of economic damages.

Con 7 defines an "expected cash flow approach" and states a strong preference for using it in performing fair value measurements using uncertain cash flows. Economic damages determinations are often based upon uncertain cash flows. Therefore the expected cash flow approach as defined in Con 7 is applicable to their measurement

There is a recognized problem, however, with the way Con 7 is understood and applied by preparers that impacts both valuations and economic damages determinations.

The purpose of this article is to help bridge the gap between theory and practice in connection with the determination of the present value of expected cash flows, to advocate a practical discipline regarding the use of risk factors for estimating future cash flows and the present value thereof within the framework provided by the "Expected Cash Flow Approach" defined in Con 7, and to disclose the source and nature of a fundamental misconception that leads to overstatement of asset values and economic damages.

The misconception is inherent in the technique by which many practitioners apply certain risk factors in arriving at the discount rate to compute the present value of anticipated future cash flows (the "Traditional Approach" as defined in Con 7).

How the problem may have come about can in part be expressed by FASB's words in its recent *Fair Value Measurement, Project Update:* "U.S. GAAP does not provide a framework for measuring fair value. Guidance for measuring fair value has evolved over time and is dispersed among the many different accounting pronouncements that require fair value measurements. Differences in that guidance have impeded FASB's efforts to communicate its Con 7 so that it can be generally understood and consistently applied by preparers, valuation specialists and auditors, creating the potential for differences in fair value measurements for the same or similar items under different accounting pronouncements."

TWO DISTINCT METHODOLOGIES

FASB Concept Statement No. 7 addresses two distinct methodologies for the determination of present value of cash flow:

1. The "*traditional approach*" wherein compensation for all applicable risk factors inherent in a single cash flow projection is reflected in a single discount rate (that is,the risk free rate plus risk factor adjustments).
2. The "*expected cash flow approach*"

a. Risk factors that cause variation to projected cash flows should be considered separately.

b. The probability of different cash flows due to applicable unsystematic or subjective risk factors should be applied in arriving at the expected cash flow or income stream.

c. The expected cash flows should then be adjusted for the systematic risk inherent in them. According to Shannon P. Pratt et al. in *Valuing a Business—The Analysis and Appraisal of Closely Held Companies,* systematic risk is "The uncertainty of future returns due to sensitivity of the return on the subject investment to movements in the return for the *investment market as a whole.*" (Emphasis added).

d. The resultant net cash flow or income stream, determined as a result of steps a, b and c, should then be subject to the "safe investment rate" to arrive at the present value.

THE BETTER, SAFER APPROACH

The "expected cash flow approach" is better and safer to use. Since both the expected cash flow approach and the traditional approach are variations of present value, each should, when applied properly, arrive at a similar result. Often, however, a material disparity exists in cash flow determinations derived from applying specific risk considerations to the individual profit and loss line items to which they relate (expected cash flow approach), as compared with inclusion of the same considerations as factors within an undivided, lump sum present value discount rate (traditional approach).

It may seem obvious at first that there is a mathematical difference in the results of a present value calculation developed by including all risk factors in the discount rate as compared with having the same risk factor issue or issues reflected as direct adjustments to the income statement (that is the source of the revenue stream to be brought to present value). Such awareness, however, does not solve the problem. The fact is that both the magnitude and ramifications of such differences are often not fully perceived or adequately considered.

Table 1 is a simplified illustration of one such scenario. The table shows variation of $264,045 in present value for just a single year, assuming a company expected the sales *prices* (not the sales *volume*, therefore the cost of sales remains unchanged) of $5,000,000 worth of product to be reduced by 14% because of competition. For purposes of comparison of results, a 14% factor is added to an assumed safe investment rate of 6% in the Traditional Approach column.

Table 1

	Traditional	Expected Cash Flow
Sales volume	**$5,000,000**	**$5,000,000**
Less: Pricing risk factors (14%)		**(700,000)**
Adjusted gross sales	**$5,000,000**	**$4,300,000**
Cost of sales (75%)	**(3,750,000)**	**(3,750,000)**
Gross profit	**$1,250,000**	**$550,000**
Fixed costs	**(500,000)**	**(500,000)**
Pre-tax profit	**$750,000**	**$50,000**
Present value: Annual convention, five years.		
@ 20% rate	**$301,408**	
@ 6% rate		**$37,363**

In the Table 1 example, as is often the case in the real world, each category of sales, sales price, cost of sales and fixed costs has an individual and distinct existence that must be considered separately in connection with their impact on expected cash flows. One of the first things to be recognized therefore is that the inherent assumption in the Traditional Approach of an "across-the-board" equality of effect on expected cash flow is unwarranted.

Secondly, while published data commonly used in the Traditional Approach may serve as a good checklist of risk factor topics to be considered, application of the numeric values of such published data should not be considered valid without due consideration of comparability with the facts and circumstances of the subject entity. Under the traditional method in the example, it would take a consolidated discount rate exceeding 80% to arrive at the proper result. Such a rate is well beyond the parameters contained in published data commonly used in the Traditional Approach.

In an article published in the *Journal of Accountancy* in January 2002, Robert L. Dunn and Everett P. Harry list nineteen discount rate risk considerations within the following subcategories that "unsystematic or subjective risk" comprises: market risk, financial risk, management risk, product risk, company sales risk, and business environment risk.

In one way or another, each of the listed risks or others as may apply in a particular case can have an impact on one or more income statement individual line items. "Strength of competition," for example, may lead to increased advertising and promotion costs as well as a reduction in selling prices; "commercial impracticality of production" may result in obtaining product from others at a higher product cost.

There is no formal linkage between published risk factor data used in the traditional approach and the financial realities of an individual company. The analyst must consider applicable business and economic circumstances specific to the entity under review in arriving at projected net cash flows (such business and economic circumstances are here discussed in the form of unsystematic or subjective risk factors). Furthermore, they must be considered in relation to the specific income statement line items to which they apply.

ANALYSIS

Table 2 is provided to demonstrate the relevant mathematics of the expected cash flow approach and to submit a basic calculation format recommended by this writer. It can also serve as a worksheet format to facilitate review by appropriate audit personnel. In that event, full explanation of the listed risk factors as well as their related probabilities and substantiation thereof would be attached. The table is not intended to represent a trial exhibit.

Hopefully, the data included in an actual analysis will constitute reasonable anticipation of events that potentially may have an impact on the future income stream.

The adjustments result from using risk factors as a checklist to ascertain those risk elements that affect the expected cash flow of the subject entity. The percentages used represent the reasonable possibilities applicable to income statement line items of the subject entity.

The $89,011 present value amount may serve as an economic damages component in many instances. If, however, the analysis is being used to determine the market value of the business, a further adjustment to the $119,117 pre-tax profit amount should be considered for systematic risk as required by Con 7.

Adjustment A represents anticipated decreases in sales. Based upon the circumstances hypothetically applicable to the entity under analysis, it was determined that a 15% reduction represents the highest *reasonable* adjustment under the circumstances and 5% the lowest. Considering the most materially relevant facts, 10% was selected as the most probable expected outcome.

Table 2

Year 5		Reasonable Outcome Scenarios		
	Low	Middle	Upper	Expected
Gross sales volume year 5, assuming sales volume of $6,000,000 year 1 and 5% annual growth	$7,293,038	$7,293,038	$7,293,038	$7,293,038
Less: Risk adjustment applicable to sales volume (not sales price)				
Reasonable variance				
A 5, 10, 15%	364,652	729,304	1,093,956	729,304
Adjusted gross sales volume	6,928,386	6,563,734	6,199,082	6,563,734
Cost of sales (79%)	5,473,425	5,185,350	4,897,275	5,185,350
Plus: Risk adjustment to cost of sales				
Reasonable variance				
B 3, 5, 7%	164,203	259,267	342,809	259,267
Adjusted cost of sales	5,637,627	5,444,617	5,240,084	5,444,617
Gross profit	1,290,758	1,119,117	958,998	1,119,117
Fixed costs	850,000	850,000	850,000	850,000
Plus: Adjustments to fixed costs				
C + 150,000	150,000	150,000	150,000	150,000
	1,000,000	1,000,000	1,000,000	1,000,000
Pre-tax profit	$290,758	$119,117	$(41,002)	$119,117
Present value @ 6% discount rate, annual convention, five years.				$89,011

Adjustment B represents anticipated increases in the price of materials and supplies included in the cost of goods sold category. Adjustment C represents known or reasonably anticipated increases in fixed costs such as rent, insurance, and property taxes.

It is assumed that the 6% amount was determined in accordance with generally accepted procedures and is valid.

Inclusion of the risk adjustments depicted above (one in Table 1 and three in Table 2) cannot safely be ignored in a damages calculation. The use of published risk factor data applied in accordance with the traditional approach does not adequately reflect these adjustments because they are unique to each situation.

CALCULATION

It is assumed that the pre-adjusted figures in Table 2 have been "normalized" (adjusted for material nonrecurring, non-economic, or other unusual items to eliminate anomalies and facilitate comparisons). If the calculation is to be applied to a majority interest, the normalized figures should be further corrected to eliminate elements of "discretionary income" prior to making adjustments on account of risk factors.

Column 4 of Table 2 serves as the calculation of the year 5 expected net cash flow and present value (without consideration of income taxes).

The data in column 4 might otherwise represent a calculation in its entirety. However, failure to calculate columns 1 through 3 will deny the analyst the certain and important benefits of an explicit consideration of risk factors and their magnitude discussed in the paradigms of analysis, presentation, and support.

The omission of columns 1 through 3 may also compromise conformity with Con 7. Inclusion of columns 1 through 3 conforms to the intent of paragraph 45 of Con 7 in connection with the expected cash flow approach, which reads, in part, as follows: "...uses all expectations about possible cash flows instead of the single most likely cash flow" and "focusing on direct analysis of the cash flows in question and on more explicit statements of the assumptions used in the measurement."

Note that Table 2 represents only one year of the period to be included in the calculation, that the summation of all years equals the results of the calculation, and the number of years to be considered may itself be subject to a range (at least for calculation purposes).

The table's format may also serve as a practical tool to determine the mean of the distribution of possible cash flows. For all practical purposes the "mean" is represented by column 4. The mean in column 4 is not an arithmetic mean but rather the mean of an implicit asymmetric distribution of the possible outcomes whose probability is represented by column 4. In that regard it is not in conformity with the rigid formal calculation elements of Con 7. Instead, they represent possible actual circumstances as may be found in the field, which circumstances are best addressed by straightforward assessment of the understood probabilities rather than by a more formal statistical analysis. However, it is well within the framework and intent of Con 7, is easier to use by CPAs as a class, and avoids the problematic task of formally assessing the otherwise required mathematical probability factors of different outcomes.

In addition, columns 1 through 3 are not intended to represent "Best Case, Most Likely, and Worst Case Scenarios" as used in the sequentially tiered averages of the "First Chicago Method." The "Expected" column in Table 2 captures compelling, if not controlling, factual circumstances applicable to the subject company and does so in connection with specific line items of the company's income statements, leading to a more reliable determination of expected cash flow. The Table 2 worksheet may also serve as a convenient format for use in annual re-evaluations required in the performance of attestation services.

PRESENTATION

In providing attestation services, if the auditor chooses to present the expected (most likely) factor total of all years, it may be desirable for the auditor to disclose that the total is the result of factually considered probabilities of outcome.

In providing litigation services, the expert needs to consider the benefits of the use of ranges. Presentation of a range for purposes of economic damage determinations and valuations is generally desirable for several reasons. One reason is that doing so helps to imbue an aura of impartiality and resultant credibility on the part of the expert. On the other hand, determination and presentation of a range may be contraindicated by controlling law in instances such as equitable distribution in divorce and separation matters.

Another benefit of presenting a range is that doing so better provides a jury or a trier of fact a choice, which is in conformity with the valuation or economic damages expert's role as a provider of information for the benefit of the court.

The consideration of ranges is one of the foundations of the expected cash flow approach as defined by Con 7. If one does not consider the ranges and the expected outcome it is hard to say that one is computing or basing the analysis on expected cash flows.

Plaintiffs should consider that use of appropriate and reasonable damage ranges allows for a choice between something and something as opposed to a choice between something and nothing.

While the expert is well advised to consider ranges in the determination of damage amounts, the expert is not irrevocably compelled to provide a range of damages as an opinion. Such consideration also allows the expert witness CPA insights to potential areas of rebuttal and thus enhances the CPA's ability to anticipate and overcome such rebuttal.

SUPPORT

One can think of no better foundation for support of one's opinion than the existence of a more thorough analysis of the relevant facts and circumstances upon which the opinion is based. In that regard, the preceding discussion of the analysis and calculation process associated with the expected cash flow approach as defined in Con 7 serves as an invaluable tool. Such analysis also better enables the CPA to meet the standard of "Sufficient Relevant Data."

The use of the Expected Cash Flow Approach as presented here avoids the numerous limitations and incompatibilities inherent in statistical data, particularly when applied in conjunction with the traditional approach. Such limitations and incompatibilities include, but are not limited to, the following:

- The assumption of a diversified stock portfolio.
- Inclusion of averages from the year 1926 to the most recent year prior to publication of the reference book, which averages may be unsuitable to the period under review.
- Inability to determine easily if a low capitalization rate is due to distress or other factors not applicable to the entity whose expected cash flows are being evaluated.
- Information taken from guideline companies will likely not have been normalized, and are thus incomparable.
- If the subject company cannot reasonably be expected to go public, there is no basis to use publicly traded stock as a measure.

An expert witness must comply with requirements resulting from the *Daubert* decision in order to ensure that the court will not throw out his or her work product and opinion. Two of the *Daubert* criterion are "Whether the technique or theory [used to determine the present value of expected cash flow] has been subjected to peer review and publication" and "The degree to which the technique or theory has been generally accepted in the scientific community." Con 7 has been subjected to peer review and publication and has been generally accepted in the scientific community.

Also, the expert's technique or theory must be able to be "reasonably assessed for reliability" and his or her testimony must be based (per rule 702) "upon reliable underlying facts, data or opinions." Accordingly, the expert should maintain clear explanation and adequate support for adjustments to expected cash flow such as those shown in Table 2. Other applicable professional standards also come into play by way of support, such as sufficient relevant data, due professional care, and professional competence.

Material conformity with the

results obtained through application, in whole or in part, of the Expected Cash Flow Approach as herein described can serve as an acid test of the reasonableness of a present value prepared in accordance with the Traditional Approach. Lack of conformity may be used as a basis for challenge.

As Pratt and others say in *Valuing a Business,* "Economic damages often require or may benefit from the use of business valuation *methods.* Both disciplines rely heavily on the income approach method. Damages experts need not consider more than one approach or method and need not limit their examination to data that were available prior to the valuation date. Any business valuation analyst who is asked to express an opinion regarding economic damages should be careful to recognize the many differences between these two disciplines." (Emphasis added).

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A Case in Point

In an actual case, the plaintiff alleged it incurred damages based upon lost anticipated profits resulting from its inability to initiate a new business venture because of the defendant's breach of contract and violation of the Fair Trade Act.

Plaintiff's CPA expert used a 20% combined present value discount rate in arriving at economic damages based upon net cash flow.

During his deposition, the expert was caused to agree that the 20% all-inclusive present value discount rate included other risk factors in addition to a 6% risk-free rate of interest. He further conceded that such additional risk factors include, but are not limited to, the following: the existence of well established competition; inexperienced management; untrained sales force; insufficiently comprehensive breadth of product range in inventory due to inadequate working capital; inadequate warehousing and inability to extend traditional credit to customers.

When pressed for his opinion about what a reasonable percentage adjustment should be *on an individual income statement line item basis* attributable to each of the above stated risk factors, the expert was caused to acknowledge that his 14% all-inclusive, comprehensive risk factor (equal to the 14% factor in Exhibit A by coincidence only) is materially understated. He agreed that as a result of such understatement the calculated net present value of the damage amount represented in his written opinion is likewise materially overstated. When the income statement line item math was presented to him, he also agreed that there was indeed no positive net cash flow and that therefore the plaintiff's damage amount equals zero.

INDUSTRY *Expert*

WHAT MAKES SOFTWARE COMPANIES UNIQUE?

By James S. Rigby, CPA/ABV

Unique issues arise when valuation analysts value a software company. An understanding of these issues is critical to analysts' ability to analyze the value of a company and to help client executives and owners understand the uniqueness of the industry in which they participate. This understanding also helps valuation analysts and their clients to recognize business risks and capitalize on market opportunities.

Every business owner believes his or her company is unique. This is right—up to a point. Most businesses are not unique in terms of their basic economic operation. Software companies are an exception. Jim Catty, a Canadian financial analyst who specializes in software, started a list of unique characteristics of software companies, which he offered in his presentation entitled "Valuing Software and Internet Companies," at the 1999 High Tech Industries Conference of the California CPA Education Foundation. Our firm, the Financial Valuation Group, has continued adding to and refining the list over the years.

The software industry's many unique characteristics include:

- *Limited market life.* The market life of a software program is limited. Generally, investors and tax authorities expect software to have a life of two to three years. However, established programs have core technology, which often can be enhanced to prolong their lifespan through several versions. Such programs have greater value because successive versions increase and extend the cash flow generated. In some cases, new versions are almost new products and extend product life significantly.
- *Economic scalability.* Software is the ultimate intellectual property. After it is created, making and selling an infinite number of copies is easy and cheap with few

costs other than copyright and marketing expenses. This cost structure (its "economic scalability") is different from that of most products and services. Thus, software can generate higher profit margins than traditional products.

- *Barriers to entry due to market forces.* Market forces, not difficulty in creating program code, are usually the primary barriers to entry for software companies. Therefore, a company must first find out if a market for the software exists and what advantage it can offer to any group or market sector.
- *Standards.* Most industries have standards, such as the layout of computer keyboards and electric line voltage (different standards in the U.S. and Europe). Standards exist for certain aspects of software, but innovation is moving so rapidly that the market determines most standards and agreement on these standards follows.
- *Value driven by future prospects.* The level of shareholders' equity (book value) has less impact on value than in traditional companies. The reason is most of a software company's assets are intangible assets, which for the most part are not included on their balance sheets and in book value. Similarly, historical losses tend to have less predictive value for future earnings in a software company than in a traditional company because of shorter product lives and rapidly changing markets. Thus, the value of a software company depends almost exclusively on investor expectations for future earnings and risks.
- *Contribution of research and development to value.* A software company expends large sums on research and development, which accounting standards usually require to be expensed as they are incurred but may help the company generate earnings in the future. For valuation purposes, to the extent that the research and development resulted in the creation of software that is expected to result in future earnings, these costs represent assets that should be recorded on the company's balance sheet rather than recorded as expenses on the income statement.
- *Unrecorded assets.* Distribution channels and the installed base of users are also important intangible assets of a software company, which do not normally appear in the company's financial records. Nevertheless, because they are essential to the generation of future earnings, they are assets that must be considered for valuation purposes.
- *Distribution through the Internet.* Distribution of software has progressed from a stack of floppies to a CD-ROM to a quick and simple download from the Internet. This latest distribution channel has substantially lowered costs and selling prices, while at the same time making it possible to conveniently generate sales from a worldwide market.
- *Some software programs becoming commodities.* Some types of software, such as "search and retrieval engines," are turning into commodities and are available on the Internet; sometimes they are even free. Thus, profits from some software have plummeted or disappeared.
- *Increasing complexity.* Computer software is constantly becoming more complex, as developers integrate more and more functions into products, such as Supply Chain Management systems, which cover the critical path from ordering components to delivering the finished product.
- *Young employees.* Because their products often are based on newer technologies learned by young people in school, many software companies tend to have a much younger group of employees than traditional companies.
- *Young companies.* The average age of software companies is much lower than traditional companies. Therefore, the typical software company executive has less management experience than his or her counterpart in traditional companies.
- *Frequently sold for liquidity purposes.* Traditional companies typically sell because owners seek retirement or must withdraw for health reasons. Software companies, however, often sell for liquidity reasons because of their need for investment capital to fuel continued high growth.
- *Difficulty obtaining financing because of dependence on intangible assets.* As previously discussed, software companies have a much greater dependence on intangible assets than do traditional companies. Most of these assets are not recorded on the balance sheets. Therefore, asset lenders such as banks may be reluctant to provide financing to software companies.
- *Fast changing technological base.* The technological base of a software company changes at a much faster pace than the technological base of traditional companies. This rapid pace of change creates employee training and marketplace positioning issues.
- *Different approach to advertising.* Small software companies must have a different approach to advertising than traditional small companies. They cannot confine their advertising to the yellow pages, local newspapers, or trade associations. Instead, they must advertise on a national or an international scale as do large companies. In addition, the advertising methods used by software companies evolved significantly over the last decade to become much more Internet based.

These characteristics contributed to the business environment in which many of the best-known software companies failed. We are all familiar with the fate of such software as Lotus 123, WordPerfect, D Base (Ashton Tate), and Netscape. A company can face the same situation, unless owners and managers understand the unique characteristics of the software industry and know how to deal with the business risks confronting software companies. The valuation analyst who doesn't consider these issues in his or her valuation analysis risks developing a flawed valuation conclusion.

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Q&A ON BUSINESS VALUATION AND FORENSIC & LITIGATION SERVICES

By Jim Feldman, CPA/ABV and Shari Lichtman, CPA

Questions from members; answers from AICPA Professional Staff

The AICPA's Member Innovation Team, Business Valuation and Forensic & Litigation Services division, answers questions from AICPA members as one of its services to members. Because other members may have the same questions, we publish some of them here. The following is based on an actual technical practice question that we received from one of our members.

QUESTION:

In a recent *Journal of Accountancy* article, Joe Wells wrote, "Holmes knows that as a CPA, he must avoid expressing opinions on the accused person's guilt or innocence as this is for a jury to decide." Common sense affirms this statement; however, I was curious if there was a specific pronouncement from the AICPA that formalizes this for CPAs. Can you point me in the right direction?

ANSWER:

First, we address your question from a legal perspective. Our legal system functions so that the determination of "ultimate questions," such as guilt or innocence (in a criminal matter) or similarly "liable or not liable" (in a civil matter), is generally the job of the jury. A good lawyer objects to an attempt by any witness—even an expert witness—to offer answers on the witness stand to ultimate questions. A good judge will sustain that objection and remind all present that that determination is the job of the jury.

Further, all statements made out of court, whether they are contained in affidavits (written statements made under oath), depositions (out-of-court oral testimony of witnesses made under oath, typically in response to questions by attorneys), or expert reports are only potential evidence until they are formally "admitted" at trial, that is, accepted by the judge. We doubt that the judge in your case would permit statements of guilt or innocence to be admitted as evidence.

Second, with respect to AICPA professional standards, there is no specific "pronouncement" from the AICPA that directly answers this question. The AICPA does, however, assist CPAs in the practice area by offering non-authoritative guidance in literature, such as practice aids. Practice aids provide valuable educational and reference material for Institute members, but do not establish standards or preferred practices.

Practice Aid 97-1, *Fraud Investigations in Litigation and Dispute Resolution Services* (AICPA product code no. 055001). Section 75/135, first part of .34 contains the following pertinent passage regarding your issue:

> *The CPA should avoid making statements or expressing other opinions that accuse the alleged wrongdoer of fraud or that attest to the innocence of the alleged fraud perpetrator. The trier of fact should reach these conclusions. The CPA should normally adhere to statements of fact that are supported by sufficient relevant data.*

Earlier this year, the AICPA published AICPA Consulting Services Special Report 03-1, *Litigation Services and Applicable Professional Standards* (AICPA product code no. 055297), which describes the general parameters of litigation services engagements and the applicability of the AICPA's professional standards. This excellent tool not only may help you critique the performance of the expert hired by your client's adversary, but also will help you to provide excellent service based upon traditional professional standards on litigation services and other consulting engagements.

James C.H. Feldman, CPA/ABV, is AICPA Manager of Business Valuation Services and Litigation Services. Shari Helaine Lichtman, CPA , is a lawyer and is a Technical Program Manager with the AICPA's Member Innovation Team, with much of her focus on Forensic and Litigation Services.

AICPA RECOGNIZES FLS VOLUNTEERS

Ron Durkin and Mike Ueltzen receive the first AICPA Forensic & Litigation Services Volunteer of the Year Awards.

The AICPA Forensic & Litigation Services (FLS) Volunteer of the Year Award was instituted in 2003 to recognize individuals who have, during their service as a member of an AICPA committee, subcommittee or task force, by their extraordinary efforts and accomplishments, advanced the litigation services or forensic accounting practice areas for CPAs. One or more of the following factors, among others, may be considered to determine the Award recipients:

- Positive impact on the profession.
- Contributions to the body of knowledge.
- Leadership role in education or training.
- Enhancing opportunities for CPAs in the profession.

Nominations are proposed by FLS (previously named Litigation & Dispute Resolution Services) Subcommittee members, FLS task force members, AICPA staff providing forensic and litigation services to members, or any other person.

CLEAR CHOICES

Ronald L. Durkin of KPMG, Los Angeles and Michael G. Ueltzen, managing partner of Ueltzen & Company, Sacramento were overwhelmingly the choice of all proposing the award. Their contributions to the profession are too numerous to list in total but the following summarizes how they were described in nominations.

Ron Durkin was the past chair of the AICPA FLS Subcommittee. During his term, he led the subcommittee in accomplishing much, including several new practice aids and the start of AICPA Consulting Services Special Report 03-1, *Litigation Services and Applicable Professional Standards* (AICPA product no. 055297). He remains committed to both the FLS program and the development of fraud detection programs. Ron is the current Chair of the AICPA Antifraud Programs and Controls Task Force. He has been a frequent leader at the National FLS and Fraud Conferences. In addition, Ron has remained active at both the state and national level in the litigation arena and continues to serve in a leadership role in California.

Mike Ueltzen was an active member of the FLS Subcommittee through September 2003. He also chaired the Task Force responsible for Special Report 03-01. He has served and continues to serve on an AICPA Professional Ethics Executive Committee task force that is addressing FLS issues. He has been a leader in providing current information to FLS practitioners about the Sarbanes Oxley Act of 2002 and SEC enactment. He is also serving as the member of a task force to update certain FLS practice guidance. A frequent speaker and leader at the National FLS and Fraud conferences, Mike also remains active at the state level and was honored in California as CPA of the Year.

AICPA WILL RETAIN SPECIALTY CREDENTIALS

At its fall 2003 meeting, the AICPA governing Council passed a resolution to retain the AICPA's Accredited in Business Valuation (ABV) specialty credential along with the Personal Financial Specialist (PFS) and Certified Information Technology Professional (CITP) credentials. As part of its approval, Council affirmed an increased investment by the AICPA in the overall personal financial planning, information technology, and business valuation and forensic and litigation services specialty practice areas, focusing on building the bodies of knowledge and disciplines that serve as the foundation to the specialty credentials and the related membership sections.

The AICPA will integrate activities of the National Accreditation Commission (NAC), relevant Executive Committees and AICPA staff in meeting credential holders' professional needs. As part of this effort, the AICPA will also develop tools and resources to help credential holders succeed in their professional activities. The resources include toolkits, advanced training, and specialized newsletters.

MEMBER FEEDBACK CENTRAL TO PROCESS

Council's resolution was in response to recommendations by the AICPA Board of Directors' approval of a recommendation from NAC, based on an in-depth review of each credential program. The review process included exploration of all possible retention and exit strategies, including outsourcing to third party organizations or elimination. Substantial feedback was also gathered from credential holders, section members, and general AICPA members through a series of research programs, including online surveys, town hall teleconferences, and an Invitation to Comment document.

For more information about the ABV credential or other AICPA specialty accreditations, visit www.aicpa.org and click on "Accreditations" in the column on the left.

FYI...

ASA AND AICPA ANNOUNCE COOPERATIVE VENTURES

The American Society of Appraisers (ASA) and the AICPA announced a new education equivalency agreement, the first in a series of collaborative ventures between the two organizations. Under the agreement, an AICPA member who has passed the ABV examination will receive equivalent credit for passing the ASA's four Principles of Valuation courses in business valuation.

The ASA awards two credentials: the Accredited Member (AM) and the Accredited Senior Appraiser (ASA) designation. ABV credential holders who wish to earn either of these designations must complete ASA experience and membership requirements and submit two appraisal reports to peer review. They must also pass examinations in ethics and in the Uniform Standards of Professional Appraisal Practice (USPAP).

In addition, the two associations will hold a joint national Business Valuation conference in 2005 in Las Vegas and will work cooperatively to explore education, training, and technical writing opportunities.

FTC PRIVACY SAFEGUARDS MAY HAVE AN IMPACT ON YOUR FIRM

On May 23, 2003, the Federal Trade Commission's (FTC's) Safeguards Rule became effective. This regulation states that financial institutions and other businesses that are subject to the rule—which could include tax preparers and financial advisers—must have in place a comprehensive program to ensure the security and confidentiality of customer information.

To find out whether you or your firm is subject to the safeguards rule and to access additional resources on compliance with other provisions of the Gramm-Leach-Bliley Act, go to www.ftc.gov/bcp/conline/pubs/buspubs/safeguards.htm.

More information about the Gramm-Leach-Bliley Act and the FTC's privacy initiatives is available at www.ftc.gov/privacy/glbact and www.ftc.gov/infosecurity.

The American Bar Association has gone to court to exempt lawyers from these provisions. Although the outcome of that decision is still pending, the AICPA is seeking a similar exclusion for its members.

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